



September 16, 1965

Letter 300

**THE MARKET:** The performance of the stock market since late July provides a dramatic example of why Wall Street holds such a continuing fascination for so many people. Those who spend their lives studying the market, keeping statistics on it, theorizing about it and charting it never know quite what to expect next. For instance (see last Letter), in the 33 trading days between July 28 and September 13 the advance-decline ratio rose an astounding total of 33 days. According to my statistics, this constitutes a stock market record. Despite this unprecedented string of rising days in breadth, neither Industrials, Rails or the A-D ratio have (so far) recovered to their previous 1965 highs.

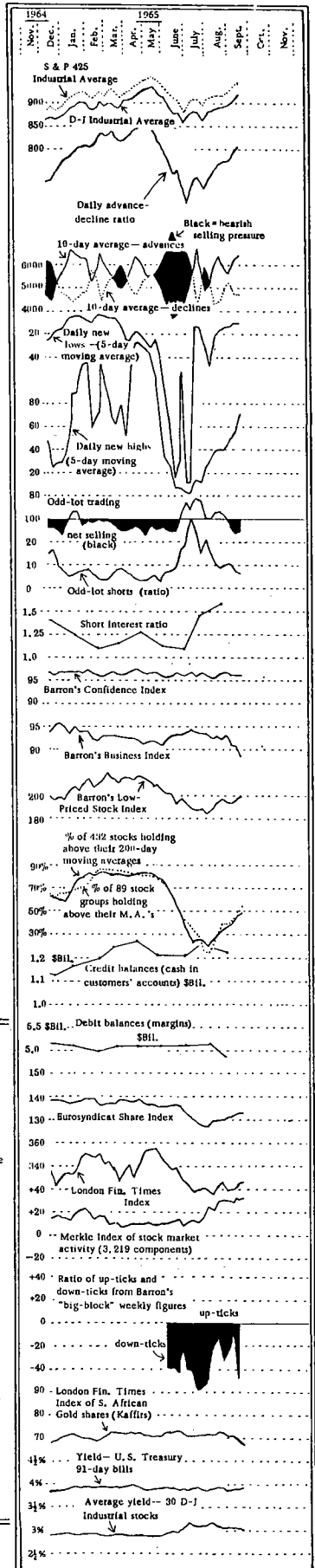
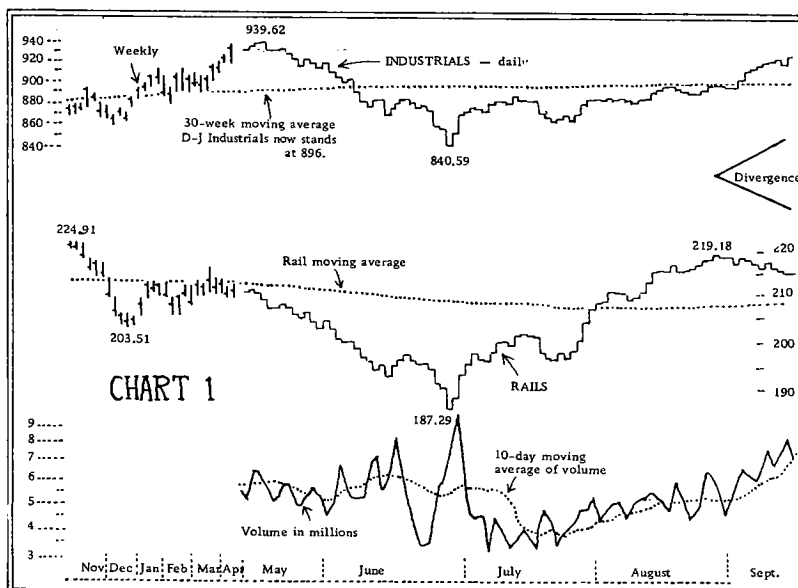
From the standpoint of the Dow Theory it should be noted that on August 27 the Rail Average touched a recovery high of 219.18. A period of very high volume divergence has occurred since then with Industrials spurring to form a "spiked" upward zig-zag while Rails sagged to trace out a series of minor downward zig-zags (see chart 1). Such periods of divergence (in which the two Averages part ways) have, in the past, often prefaced a period of minor "rest" or consolidation for the market. At other times, periods of divergence have proved to be the forerunners of reactions or even of major bear market declines. It is too early to tell whether the divergence which began on August 27 is fated to be a minor pause preparatory to an assault on the 1965 highs — or whether the Averages are saying that there is serious trouble ahead.

The news for investors, at least on the surface, has been happy. President Johnson appears to be ready to eliminate all major strikes (regardless of the resultant pay package) by way of Presidential "persuasion" and the force of his personality. Thus the threatened steel strike is already a memory. Britain has gathered up another list of potential "pound supporters," and it is now generally conceded that Britain is going to get by the fall without devaluation. Car sales are continuing to churn away, and according to the Newsweek survey a capital goods boom ahead will insure prosperity during 1966.

The few who are now cautious point to a continuation of the Vietnam war ("old hat"), and the possibility of a spread of the India-Pakistan conflagration. From the financial side, they note that interest rates are tightening (see bond section in this Letter). Increased interest rates are being ushered in due to pressure of high interest rates from abroad and from domestic pressure due to a rush of corporate borrowings for modernization and expansion purposes. Declining bond markets have often proved to be the signal for trouble in the stock market, but this thesis has yet to be proved on the current recovery.

\* \* \*

As of Thursday (September 16) Industrials had advanced to within 2% of their May, 1965 high of 939.62. Thus the huge "broadening pattern" referred to in recent Letters (see chart 2, page 2) is a step nearer completion. It should be remembered that broadening formations are by nature erratic and violent. Any intra-day high above the old 940-944 level (point 3) would serve to give us a potential point 5 on this extraordinary pattern, and if this does occur I would expect the market to become more



"excited" and explosive than ever. A preview of the potential excitement was seen last week when on Tuesday Industrials dropped 4.33 (on 7.8 million shares). On the next day the market reversed as suddenly as it had dropped, and Industrials rocketed to a new recovery high.

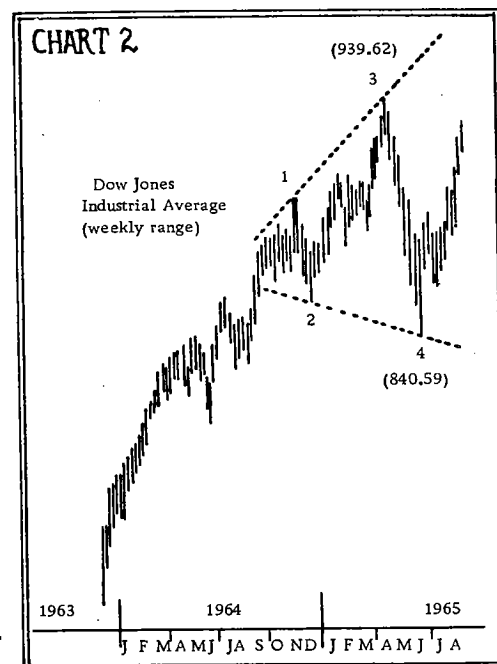
The Composite Chart (page 1) shows the leading industrial averages pushing to within 2% of their May highs. The A-D ratio (although not within range of its own 1965 high) has advanced "in gear" with the averages. The 10-day advance line is above 6000 again, showing buying power in the dominant position. Daily new highs (5-day av.) rose above 80 last week, but still well below the 120-30 peak of early 1965. Odd-lotters maintain their selling stance. Barron's Confidence Index has spent its third week at 96.2. Barron's Business Index has dropped to 88.5 due largely to the slowdown in steel production. The percentage of stocks holding above their moving averages has risen to 48%, while the percentage of stock groups holding above their moving average has risen to 55%. The large blocks continue on the downside with a big minus reading of -50 for the week ending September 9. Since June 7, Barron's has listed 496 big blocks of which 66 have been on up-ticks and 299 on down-ticks. This is an unpleasant reminder that big money is continuing to leave this market. The S. African gold index has dropped to 68, due to the promise that Britain will "get by the fall" without devaluation. Average yield on the Dow is 3.04 while the average yield on the Standard and Poor 425 Industrial Index is now 2.92 — both dangerously low.

Conclusion: For the short term the market is "overbought," but such periods can last for weeks. The Rails are already well into a corrective phase, and it will take time to determine just what the three week decline in Rails signifies. For the long term such factors as the major decline in debit balances, the persistent big block down-ticks, the deteriorating bank credit statistics and the very low average stock yields tell us that the market is plowing into increasingly dangerous territory.

"THE BIG BLOW-OFF"? Ever since 1959 many historically oriented analysts have been watching and waiting for the big blow-off ("just like 1929"). Such a speculative period, it was believed, would serve to end the great post-World War II bull market. In 1959 the low-priced stocks or "cats-and-dogs" (not to be confused with new issues) did surge, and that year Barron's Low-Priced Stock Index touched an historic high. But 1959 just did not seem like 1929. The volume was not there and the froth was not really there. The market declined sharply into October, 1960, then came back in late 1960 and 1961.

In 1961 we saw the first genuine new issue market since 1945. Every company with an -onics or an -ology after its name was wrapped up in a shiny new prospectus and sold to an eager public, often at absurd prices. On top of this the "glamour stocks" or "high flyers" gave the whole affair a 1929 look — but not quite. Stocks such as Brunswick and Texas Instrument careened into the hereafter. But again volume did not seem to be quite high enough, and the frenzy did not seem quite frenzied enough. In 1962 the new issues, the high flyers and the general market collapsed. For the first time a decline showed promise of developing into another 1929 crash — but then the end came. By June, 1962, the downward momentum was spent. Following the October Cuban panic, the market again turned up.

Many analysts have expected the current rise to produce the long-awaited speculative frenzy, the froth which would finally qualify the move as "another 1929." But I have doubted this theses. Both my own historical



FROM RUSSIA WITH TROUBLES: In Letter 292 I listed the bull market peaks of various stock markets of the Free World. London hit its bull market high in October, 1964; France struck a high in April, 1962; Germany in June, 1961; Italy in June 1961; Switzerland in September, 1963; Canada in May, 1965 (along with our own); Australia in February, 1964; Japan in August, 1961.

Unfortunately for market historians, Russia has no stock market, and we therefore have no way of knowing what "informed money" thinks of the future of Russian "business." However, we are now receiving enough information so that we can guess that Russia is deep in the throes of a bear market of her own. This is something which I had always suspected would happen. With almost all the nations of the Free World now in various stages of bear markets (although the U. S. situation is not yet clear enough for everyone to see), it was to be expected that the world-wide bear trend would also catch the Russian bear in its grip.

That Russia is in deep trouble is now clear. Following the 1963 agricultural fiasco which necessitated the expenditure of \$500 million in Russian gold for Western wheat, we now see that the 1965 crop has again failed with the result that perhaps \$450 million in gold will again be spent by Russia for Western wheat. This is a bitter pill for the Communists to swallow.

Reports are now coming in of labor surpluses in Moscow, Odessa, Leningrad and other large Russian cities. The collective farm systems of Russia have obviously failed, we even hear of a shortage of hay for livestock. Huge surpluses of goods are piling up in Russian stores and factories, and much of this inventory is said to be either of shoddy construction or unwanted because of poor design and lack of consumer appeal.

Evidently, the Russian state has become one giant W. P. A. with much duplication of employment, inefficiency, and plain incompetence. Young people have been leaving the farms for the cities in large numbers, and this together with a cut of 100,000 in the Russian armed forces since 1963 has created unemployment in the cities.

On August 17 the London Financial Times reported: "Recent events have finally shattered the myth that planning gives the Soviet Union immunity from economic problems. Hard on the heels of the news of widespread unemployment and another poor harvest, there comes a call from one of the country's electricity chiefs for economies in the use of coal and electricity throughout industrial European Russia. Some of the Soviet economic problems reflect a greater willingness to publicize faults, but the search for real economies in production has revealed major shortcomings."

From U. S. News and World Report (Sept. 13) comes an ominous comment: "An American official who is an authority on Russian economic affairs put it this way: 'A Russian depression. Why not? That description is thoroughly justified. You'd have Russians on street corners selling apples — if they had the apples and the freedom to do so.'"

What does all this mean for the U. S.? This observer takes no comfort from the reports of Russia's economic plight. A nation in economic trouble is a nation under pressure; it also means a nation which is apt to be unstable. Already there are rumours that Party Chairman Brezhnev is on his way out. It looks like a grim period ahead for Russia — with the shadow of Red China (see last Letter) waiting on the sidelines.

studies and the debit-credit studies of Dr. Sloan Wilson have jibed regarding a phenomenon which we call the "post-crash syndrome." This is our observation that following a true crash (such as 1929, 1937, 1947, 1962) the public appears to suffer such severe financial and psychological damage that it does not enter the market heavily again for many years. Therefore, it has been no surprise to Dr. Wilson or myself to see a general reluctance on the part of the public to enter the 1962-65 market. To be sure, the public has been a heavy buyer of mutual funds, and it is possible that this is where their money has gone during 1962-65 (rather than into low-priced stocks, new issues and high flyers). Will the public's reticence towards the market continue to the final top? I rather think it will. There may be some switching to odd-lot buying on balance, and there may be some step-up in speculative sentiment, but in general I believe the public (as it has after previous crashes) will be wary of coming in "with both feet" again. The current rise will therefore probably "top out" with different characteristics than those which appeared during 1959 and 1961. Those who are watching for a repeat of the '59 and '61 tops should bear this in mind.

**TREASURY BONDS:** Treasury bonds represent a large segment of the towering debt of the U.S. Government. The U.S. has approximately \$90 billion outstanding in long-term bonds (maturities of five years or over) plus about \$58 billion in notes (maturities of from one to five years). Not counting savings bonds, the U.S. also has about \$55 billion outstanding in short-term (less than one year maturities) Treasury bills.

This massive debt is held by investors, institutes and banks throughout the nation. What happens in the huge Treasury market has a direct bearing on the fortunes and psychology of all of these large institutions and investors. An important decline in Treasuries exerts a double effect: (1) A decline may result in the loss of hundreds of millions of dollars in the portfolios of institutions. (2) A decline in bonds widens the disparity between bond and stock yields, and therefore puts pressure on the stock market. The higher the average bond yield, the greater the relative "overvaluation" of common stocks in terms of yield. For instance, currently the large investor has his choice of a long list of Treasury bonds yielding up to 4.28% as against common stocks which are now providing an average yield of 2.92% (on the basis of the Standard & Poor 425 Industrial Average). As the stock market rises and as the bond market declines, this yield disparity widens and the pressure on investors to justify common stocks increases.

At present, the argument for common stocks (aside from increasing earnings) is based on inflation. With the intensification of the Vietnam war coming at a time when the nation's economy is already operating at a high rate, the further addition of massive "Great Society" spending is serving to stampede many a skeptic into common stocks. In the face of this the money supply of the U.S. is being allowed to rise to record levels. The results are inevitable, a further build-up of foreign claims against the dollar (such claims rose \$200 million in the last three weeks) and further inflationary pressures on prices and wages and the cost-of-living.

All this inflationary pressure naturally brings up the specter of a possible further rise in the discount rate to perhaps  $4\frac{1}{2}\%$ . Many observers wonder how much longer Reserve Board Chairman Martin can wait before "bending against the wind" again. It is the possibility of such a discount rate rise which is now depressing the bond market. A second pressure comes from foreign sources. Comparable French bonds are yielding  $1\frac{1}{2}\%$  more than U.S. bonds while German bonds are yielding better than 2% above U.S. bonds. This type of disparity also exerts pressure on U.S. bond prices.

Referring to the historical chart, the late-1959 weakness in the bond market lead to chaotic conditions in the Treasury market. The result was our Government's offering of the famous "Magic Fives," which were five-year notes bearing a sensational 5% interest. Along with tremendous and newly aroused interest in the bond market, the stock market dropped 120 points.

The possibility of recession in 1960 caused authorities to ease up in the money market and by August, 1960, Barron's Treasury Index had risen to a high of 92.08. A second peak occurred in the bond index in mid-1961 at 92.00, just 8¢ under the 1960 high. This "double top" was followed by a sharp decline to 86.79 recorded in February, 1962 (just before the 1962 stock market collapse).

The rise from the 1962 low took the bond index to a third top of 91.33 in late 1962. From there the bonds sank to a low in 1964, at which point heavy Government "support" (buying) served to bolster Treasury bonds. Over the past few weeks renewed pressures have pushed Treasuries to the lowest point since 1964. It will be most interesting to see whether the bond index holds above its 1962 low of 86.79 in the period ahead.



Page 4 Here are some other late developments in the gathering bond picture.

Last week (see accompanying chart from the Wall Street Journal) average yields on municipal bonds (which are free from Federal income taxes) rose to 3.40%, highest yield since late 1962. This dramatic event means that these average tax-free yields are now four tenths of a percent above average common stock yields.

U.S. law places a statutory ceiling of  $4\frac{1}{4}\%$  on Treasury bonds; in other words the Treasury cannot issue a bond with a coupon of more than  $4\frac{1}{4}\%$ . But due to the slump in the bond market, a count last week showed 11 out of the 40 listed U.S. Treasury bonds now yielding above the  $4\frac{1}{4}\%$  ceiling (in the open market).

To meet the rising rates in the money market, banks last week raised their own rates on certificates of deposit (running over a year) to a new high of  $4\frac{1}{2}\%$ . Due to competition from bonds and bank certificates, the savings & loan institutes have begun to run into stiff competition for deposits. In July the S & L's lost \$400 million in withdrawals, probably the greatest monthly loss ever sustained by these institutions.

**STOCKS:** Traders Research (1431 Pearl St., Alton, Ill.) lists the following as the five strongest groups this week on the basis of their relative strength ratings: (1) Gold, (2) Airlines, (3) Sulphur, (4) Photography, (5) Aircraft. The five weakest groups are (42) Meat packing, (43) Building supply, (44) Cosmetics, (45) Paper, (46) Amusement.

Although I am receiving surprisingly few letters which ask the question "What shall I buy?" I know that this thought must be on the minds of many subscribers. My policy for long-term investors has been to move out of all stocks during this advance and to place portfolios in the most liquid position possible. The goal has been 85 to 90% of one's holdings in 90-day U.S. Treasury bills with perhaps 10 to 15% in gold shares. But if the Dow goes to 975 or even 1000 doesn't this mean that we are going to miss many exciting moves in individual stocks? The answer is obvious — yes. Well, in view of the fact that so many other services are recommending new selections for purchase, why am I so reticent? The answer is that from experience I know that the great majority of my subscribers tend to think in terms of major movements. They do not switch their thinking or psychology quickly. They tend to think and act in terms of six months to a year. My belief is that the odds are against the average buyer here in any diversified group of say five or more stocks. I do not like to talk in terms of selling all long term holdings and at the same time suggest short term speculative purchases.

Consider this; a buyer must have conviction when he makes a purchase. If one purchases five stocks here and the market suddenly turns down, could I in good conscience insist that the purchaser grit his teeth and hold those five stocks? My answer is that I could not, and this is the best argument I know for a "sidelines" or "watch the market" approach to Wall Street at this time.

**Late Notes:** The divergence as shown on chart 1 is most extraordinary, and it has been accompanied by extremely heavy volume. On September 15 (Wednesday) Industrials closed at a new recovery high while Rails sank to a new low on the (Rail) decline which began on August 27. Thus the two Averages have continued to follow separate paths, and such action should always be watched with care.

Robert Rhea wrote a good deal about divergences. He seemed to think that divergence in "bottom areas" on low volume was not particularly significant, but he noted that many serious declines have occurred in areas wherein the two Averages (following an extended advance) diverged to the accompaniment of high volume.

Writing of the big advance which terminated in 1909 Rhea said: "When the Averages disagree, they are shouting 'be careful.' Except for uniformly high volume, nothing indicated the forthcoming collapse; however, it could be seen that a great deal of fuel was being burned in the stock market boiler without generating enough steam to carry the price structure forward."

\* \* \* \*

The market opened up sharply on Thursday (September 16) as we go to press. By the second hour Industrials had advanced over five points and Rails were up almost a point. Many stocks are exhibiting "blow-off" characteristics as is the market in general. There is undoubtedly a good deal of "panic covering" among short sellers, and this too is adding to the explosive character of the market. It is a good policy to become enthusiastic when the market is down and dull, and to remain calm, very calm, when the market is excited and up.

## Municipal Bond Yield

